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First National City Bank Monthly Letter

Business and Economic Conditions

New York, May, 1956

General Business Conditions

THE drop in the bond markets and the increases in Federal Reserve Bank discount rates have made April an eventful month in business. A heavy demand for money is in itself a sign of high activity and expansive trends, and general business reports reflect the same conditions. However, the effect of money market tightening and the purpose of Federal Reserve policy is to put a little more pressure on the brakes. It is not surprising that the month's developments have led to fresh analysis and reappraisal of the outlook.

In the early weeks of this year expectations were voiced in some quarters that the next developments in the money markets and in Federal Reserve policy would be toward ease. It was argued that over-all demand was no longer rising, that the trend of production and trade indexes was at best only sideways, and that with productive capacity increasing inflationary dangers were subsiding. As events have shown, these arguments did not take account of all the elements in the economic situation, and they were never persuasive to the Federal Reserve officials, who followed a policy of sustained credit restraint and watchful waiting. Nevertheless, these expectations induced complacence as to the position of the bond and money markets, despite the immense capital expenditures scheduled by corporations and local government bodies, and they appear to have influenced deferment of borrowing to some extent.

The error in the estimates of money requirements was exposed by the heavy demand for loans which fell upon the country's banks on March 15, when corporate income tax payments became due. Exceeding expectations, this demand in the week ended March 21 increased the business loans of the New York City banks alone by $436 million. The significant revelation was that the borrowing corporations needed their cash for the huge programs of plant and equipment expenditures to which they were committed. The ensuing drop in the bond markets supplied further evidence that the demand to finance capital projects was running ahead of the supply of savings.

At the same time the persistent rise in industrial prices has continued, and further wage advances are in the making. Total construction contract awards in March and the first three weeks of April (as compiled by F. W. Dodge) set new highs for this time of year and residential awards rose to all-time records, indicating that the home building decline has flattened out and probably turned upward. The business news thus has presented a picture of an investment and construction boom financed by excessive borrowing, and contributing to a wage-price spiral. The discount rate advances served as a warning that brick and mortar investments should be financed by long-term capital, rather than by bank loans.

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Industrial and Trade Trends

Business indexes for April, when the final figures are in, are expected to continue close to earlier months' levels. The industrial production index of the Federal Reserve Board (1947-49=100) has held between 142 (March) and 144 (December) since last September. Total retail sales, seasonally adjusted, in March recovered 2 per cent above the February low, but were 1 per cent less than the September peak. Nonagricultural employment rose a little less and unemployment declined a little less than usual in March, while average hours worked in factories dropped a little to the lowest figure since January 1955. The gross national product during the first quarter reached an annual rate of $399 billion, but this was only $1.7 billion above the rate in the fourth quarter of 1955, and the gain reflected higher prices more than physical expansion.

Looking at the over-all figures alone, it would be difficult to find the source of inflationary pressures. Indeed, the fact that a drop of nearly one third in passenger car production and contraction in some other lines has been absorbed without significant decline in aggregate output and employment is gratifying. However, the over-all stability conceals divergencies of movement.

The production index ceased to rise for two reasons. On the one hand, demand for automobiles, farm implements, synthetic fibers and some other consumer products declined, and output was curtailed accordingly. On the other hand, industries which have a greater demand than they can supply, such as steel and many of the nonferrous metals and machinery and equipment items, cannot increase output much because they are against the ceiling of capacity. Lack of steel, copper and aluminum imposes limits on durable goods output and heavy construction. Other materials, including cement, paper and nickel, are in short supply despite peak output. Skilled workers are becoming increasingly hard to find. For all these reasons production cannot rise proportionately with demand – bottlenecks and soft spots exist together.

The key item in the changes in business activity between the fourth quarter of 1955 and the first quarter of 1956 was an increase of $1½ billion, annual rate, in business investment in new construction and equipment. Probably this rate is higher now. Business plant and equipment expenditures are scheduled to total $35 billion this year, exceeding 1955, which was itself an all-time record, by 22 per cent. Heavier government spending for public works, defense, and other projects is generally anticipated.

The Wage-Price Spiral

The impact of the demand for construction and equipment falls heavily on the bottlenecks, where supplies cannot be proportionately increased, and puts corresponding pressure on prices. At the same time the effect of cost increases, including higher wages, goes around the circle. In an atmosphere of full order books, rising prices, and difficulties in getting and keeping skilled workers, union leaders will make all they can of the opportunity to demand large wage increases, and some employers may not be inclined to resist very strongly. In the steel industry, formal negotiations to replace the union contract expiring June 30 have not yet begun. Yet so strong is the belief that there will be a sizable wage increase, followed by a commensurate price boost, that a scramble to accumulate steel, so far as limited supplies permit, has been under way for some time.

Wage patterns this spring are being boosted by law (minimum wages up one third), by previous contracts (auto workers will get 6 to 8½ cents more per hour on June 1), and by collective bargaining. Whatever the method, these raises have a double-barreled effect on prices through increasing both costs and purchasing power. It is also worth remembering that the rising volume of spending for plant and equipment, public works, and the like generates a rising flow of consumer income without contributing currently to the supply of consumer goods.

The Bureau of Labor Statistics comprehensive price index for industrial goods has risen steadily since last June at the average rate of about 0.5 per cent a month. This advance, equivalent to 6 per cent a year, demonstrates the inflationary pressures. The over-all wholesale price index, including farm products, has risen during the same period at a rate of about 3½ per cent per annum. The consumer price index (cost of living) rose 0.1 per cent in March. The Bureau of Labor Statistics in publishing the figure said that a seasonal rise in food prices can be expected from now through the summer, and that it will cause some rise in the cost of living index.

Excessive borrowing, pressure at bottlenecks, rising wages and prices are all evidence that people are trying to get more out of the economic organization than it can presently produce. This is the general situation, despite the soft spots, and it is the essence of the inflationary trend.

Walter W. McAllister, Chairman of the Federal Home Loan Bank Board, put the problem in a speech in New York on April 23. In contrast to Federal Housing Administrator Cole's objective

of building 1,300,000 more housing units this year, Mr. McAllister suggested 1,100,000 or 1,200,000 as a more practical goal:

> If we tried to sustain in excess of 1.2 million units, with the balance of the economy continuing at its present level of production, we simply wouldn't be able to do it. We wouldn't have the labor or materials and we certainly wouldn't have the funds.

The Outlook

In reappraising the business outlook most people will ask two questions. First, what is the importance of the well-advertised "soft spots"? They are unlikely to disappear soon. Well over 800,000 new 1956-model passenger cars are in dealers' stocks and must be worked off before the introduction of new models in the early fall. Current passenger car production rates are roughly in line with domestic sales; before inventories can be reduced substantially, sales must be boosted or production cut. Inventory reduction is also necessary in agricultural machinery and to a less marked extent in some other lines. Even the booming steel industry faces a possibility of lower demand in the third quarter because of inventory liquidation. Roger M. Blough, chairman of U. S. Steel, stated in late April:

> A number of purchasers of steel are borrowing for the purpose of building up inventories. We believe that inventories are being built up at a rapid rate at this time. There are exceptions, like plates, structurals, and pipe, which are in short supply. But all other products are being accumulated in inventory — sheets, strip, rods, bars, and tin plate products.

Inventory liquidation in these lines may offset accumulation elsewhere during the summer months, and to that extent the pressure of demand may be lightened. Business inventories (nonfarm) rose during the fourth quarter of 1955 at the rate of $5.1 billion annually, and during the first quarter this year at the rate of $4 billion. On the whole, however, stocks are no greater in relation to sales than a year ago.

The second question is whether tighter money will reduce investment and construction expenditures below previous expectations. Inventory liquidation is unlikely to go far or to have a major depressing effect as long as capital expenditures are maintained.

There is little reason to doubt the firmness of business expansion and modernization plans. They are parts of long-term programs for cost-cutting, introduction of new products, and supplying growing markets. The extent to which commitments have already been made is evident from heavy unfilled orders for machine and other tools, dies, and specialized capital goods of all kinds, including shipping and railway freight cars. For the remainder of 1956 at least, the prospects of any material slackening in the heavy goods industries are small indeed. They promise to be exempt from the "rolling readjustment" that is affecting some sections of the economy, and the direct and indirect employment that they give will provide strong support for consumer income and expenditures.

With tax-exempt bond yields rising, there are already intimations that the increased cost of borrowing may be causing some deferment of municipal and other local government projects. Also, business men who come forward with new programs for capital expenditures are having to pay a little more for the money and in some cases may be unable to find the funds. It does not necessarily follow, however, that this will result in curtailment of present prospects in the capital goods industries, which are based on firm orders and firm plans.

Of course, a holding of the line is precisely what is wanted. Eventually, the far-ranging spending plans of business, government, and consumers will have to come into line with the ability of the economy to produce the desired materials and finished goods. Through tightening the credit supply, the authorities are causing lenders and borrowers alike to make a careful reappraisal of capital expenditure plans, inventory accumulation, and other programs. To the extent that greater selectivity in the use of credit brings about the deferment or cancellation of marginal spending plans, the pressure on the supply and prices of materials will be reduced. If curtailment seems to go too far, flexible money policy of course will take that into account at the time. For the present it clearly is based not on expectations, forecasts or fears, but on the facts as they now appear.

The President's annual Economic Report, released January 24, discussed the lesson of 1955 and had some things to say that are equally relevant to at least the early months of 1956:

> Success in preventing depression depends in large part upon a willingness to avoid the excesses that can so easily develop during prosperity and upon skill in doing this. Governmental measures of monetary and fiscal restraint are not as readily accepted as are measures of economic stimulation.
>
> The manufacturer who sees an opportunity to expand his activities by borrowing cannot always understand why his bank is so short of funds that he must put up with a smaller loan than he requested. Nor can the homebuilder or merchant or consumer. Nor, for that matter, can the banker.
>
> To each participant in the economic process a shortage of credit may appear as a restriction on his own opportunities. But the basic shortage under conditions of

high prosperity is on the side of physical resources, not on the side of money or credit.

If credit on easy terms were available to everyone at a time when the economy is already working close to capacity, the consequence would be a scramble for limited resources and a cumulative bidding up of prices. If taxes were simultaneously reduced, this inflationary process would only be speeded up. A government that sought to prolong prosperity by such devices would be taking a road that all too often has ended in disaster.

First Quarter Corporate Earnings

Reports for the first quarter issued during April by several hundred corporations indicate that sales and earnings for business as a whole continued around previous record-high levels and that a majority of the industry groups realized substantial gains in both gross and net income as compared with the first quarter of a year ago. The over-all totals, however, are held down by the decreases in a minority of groups, especially the important automobile and parts manufacturing industry.

In the electric, gas, and telephone utility fields practically every system is reporting continued growth in both gross and net income, but for the railroads an increase in operating revenues has been more than offset by rising expenses and taxes.

Our tabulation of the reports for the first quarter published to date by 777 companies shows combined net income after taxes of approximately $3.1 billion, an increase of 11 per cent over the first quarter of last year, with three out of four reporting companies showing increases. As compared with the preceding quarter, from which there is usually a seasonal slackening, the first quarter of this year brought decreases for a majority of the reporting companies and a dip in combined net income of 8 per cent.

The accompanying condensed summary gives the changes by major industry classifications. This group is representative mainly of the country's larger organizations and comprises a substantial segment of total corporate business.

In the manufacturing industries the majority of groups continue to reflect boom demand and the benefits derived from expanded and modernized plant capacity. For all reporting manufacturing companies the gain in net income over a year ago amounted to 12 per cent. Excluding, however, the decline of 15 per cent experienced by the automobile and parts group, the combined net income of the other manufacturing companies increased by 20 per cent.

Sharp gains occurred in the steel and metal industries generally, which this year have been operating at full blast yet still are unable to meet all of the country's demands. Other lines which scored sizable gains include food products, beverages, tobacco, paper, drugs, and petroleum. Textiles made some recovery from the depressed levels of a year ago. Earnings in the electrical equipment group were down largely because of a major strike.

Among individual companies there was the usual diversity of experience, some companies reporting declines in the face of a favorable showing of their group as a whole. Factors having an adverse effect upon earnings in many cases include the upward trend in prices of industrial

NET INCOME OF LEADING CORPORATIONS FOR THE FIRST QUARTER
(In Thousands of Dollars)

No. of Cos.	Industry Groups	Reported Net Income After Taxes First Qr. 1955	Fourth Qr. 1955	First Qr. 1956	Per Cent Change From First Qr. 1955	Fourth Qr. 1955
27	Food products	$ 41,818	$ 56,078	$ 47,219	+13	—16
15	Beverages	7,505	17,373	8,499	+13	—51
18	Tobacco products	30,981	42,426	36,462	+18	—14
30	Textiles and apparel	26,038	36,691	32,057	+23	—13
10	Tires, rubber products	23,022	30,658	23,033	+—	—25
30	Paper and allied products	45,801	51,663	57,516	+26	+11
35	Chemical products	212,867	284,069	235,348	+11	—17
18	Drugs, soap, cosmetics	45,373	52,935	64,798	+43	+22
38	Petroleum producing and refining	560,907	672,973	676,312	+21	+—
45	Cement, glass, and stone	79,659	99,757	88,234	+11	—12
33	Iron and steel	208,374	314,527	290,408	+39	— 8
25	Electrical equipment, radio and television	80,620	81,037	55,239	—31	—32
39	Machinery	31,819	45,531	46,022	+45	+ 1
102	Other metal products	142,419	205,236	191,658	+35	— 7
44	Automobiles and parts	497,008	498,818	422,205	—15	—15
25	Other transportation equipment	38,654	60,750	43,909	+14	—28
50	Miscellaneous manufacturing	66,222	90,307	77,691	+17	—14
584	Total manufacturing	2,139,082	2,640,829	2,396,610	+12	— 9
24	Mining and quarrying	33,738	45,299	38,442	+14	—15
29	Trade (retail and wholesale)	14,025	26,613	19,533	+39	—27
22	Service and amusement industries	12,907	18,641	15,781	+22	—15
39	Railroads	155,458	206,458	142,891	— 8	—31
76	Electric power, gas, etc.	223,208	194,279	256,039	+15	+32
3	Telephone and telegraph	161,390	179,096	183,140	+13	+ 2
777	Total	$2,739,803	$3,311,215	$3,052,436	+11	— 8

raw materials, mounting labor costs, increasing over-all tax burdens, and advances in distribution and overhead costs.

Most of the manufacturing companies in our tabulation reporting their dollar figures of sales billed show increases over a year ago, with the combined total up 11 per cent. An almost proportionate rise in operating costs, however, held the gain in net income, as already stated, to 12 per cent. Following is a summary, partly estimated, of the changes:

Sales and Net Income of 584 Manufacturing Corporations in the First Quarter
(In Millions of Dollars)

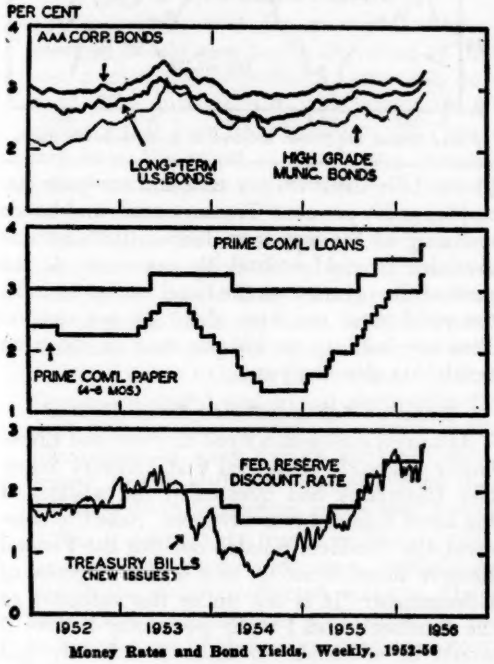
	1955	1956	Change Amount	Change %
Receipts from sales, etc.	$29,268	$32,600	+3,332	+11
Total costs, except taxes	24,974	27,877	+2,903	+12
Balance before taxes	4,294	4,723	+ 429	+10
Federal income taxes	2,155	2,326	+ 171	+ 8
Net income after taxes	2,139	2,397	+ 258	+12
Taxes to balance before taxes	50%	49%		
Net income per sales dollar	7.3c	7.4c		

Discount Rate Advances

April saw another circle of discount rate advances by the twelve Federal Reserve Banks. The Reserve Banks of San Francisco and Minneapolis moved their rates up ½ to 3 per cent. The others, including the Federal Reserve Bank of New York, went up ¼ to 2¾ per cent. Meanwhile, in their jointly conducted open market operations, the Federal Reserve authorities sold government securities, absorbing funds in the money market and adding to the pressure on banks to borrow. Member bank borrowings from the Federal Reserve averaged $1.1 billion during April, higher than in the first quarter of the year and slightly above the $1 billion peak of November.

This is the fifth in the series of discount rate increases which, over a period of one year, has carried the rate of the New York Bank from the low level of 1½ per cent as recently as April 14, 1955 up to 2¾ per cent effective April 13 of this year. The rather common assumption in the market was that further rate advances in the weeks ahead may make the higher level effective throughout the country. This was what happened with the split rate that emerged last August when the Cleveland Bank went up ½ while the other banks advanced ¼ point.

Almost simultaneously with the discount rate boosts, major banks adjusted their prime loan rate, to business borrowers of the highest credit standing, from 3½ to 3¾ per cent. Commercial paper dealers marked up prime 4-6 months commercial paper ¼ to 3¼ per cent. Yields on new issues of 91-day Treasury bills, which fluctuated between 2.17 to 2.60 per cent during the first quarter of the year, moved up around 2¾ per cent. All these short-term rates and yields reached the highest levels since 1933 when the long siege began of artificially low money rates designed to encourage people to borrow. The problem now is to hold a curb on borrowing.



Money Rates and Bond Yields, Weekly, 1952-56

Bond Market

Bond prices extended their declining movement that began around the middle of February, influenced not only by the prospect of a possible discount rate advance, but also and more fundamentally by the heavy requirements for borrowed money to finance construction projects of manufacturers, public utilities, local government bodies, home builders and commercial builders. Yields required to be offered on new corporate bond issues of high grade reached the range of 3¾ to 4 per cent, up at least ½ point from the levels of mid-February and near the levels experienced during the money pinch of 1953. On new offerings of tax-exempt State and local government bonds, yields rose to the range of 2¾ to 3 per cent, again up ½ point or more since mid-February but clearly short of the levels reached briefly in June, 1953.

The bond market showed an improved tone the last week of April as the new scale of yields broadened buying interest.

The yield curve on U. S. bonds developed the flattest contour in more than twenty years. With

Friday Closing Bid Prices, Selected U. S. Government Bonds

91-day bills about 2¾ per cent and one-year maturities at 2⅞ per cent, Treasury notes and bonds maturing all the way from 1958 to 1995 became available to yield around 3⅛ per cent. At the peak of the pressure on the bond market in 1953, the yield curve ran from about 2⅜ per cent on Treasury bills up to 3¼ per cent or more on bonds due after ten years.

Reserve Independence Reconfirmed

At a press conference April 25, President Eisenhower indirectly confirmed that Treasury Secretary Humphrey had questioned the wisdom of the latest discount rate advances. Asked to comment, the President pointed out that the Federal Reserve Board is set up as a separate agency of Government: "It is not under the authority of the President, and I really personally believe it would be a mistake to make it definitely and directly responsible to the political head of the State." At the same time he expressed confidence that the Board "will move in the other direction in some way or other as soon as they can" if money gets too tight.

This episode confirms the Federal Reserve's independence, rewon in 1951 after a long controversy with the Treasury and a Congressional restudy of the question. On the other hand, it is proper that the Federal Reserve should solicit the opinion of the Secretary of the Treasury, particularly when, as in the case of Mr. Humphrey, he is one who has been in the forefront of the contest for sound money.

As the President said, the move was argued a long time with different individuals holding viewpoints on both sides of the fence. A higher discount rate level need not, as some fear, involve any unwarranted constriction of the supply of credit provided banks are allowed reasonable freedom of access to borrowings at the discount window and open market operations are administered with a view to the essential credit requirements of the economy.

The Farm Bill Veto

In vetoing H. R. 12, "The Agricultural Act of 1956," President Eisenhower followed the only course consistent with the principles that have underlain this Administration's farm policy from the beginning. These embrace the key proposition that too-long maintenance after the war of high rigid support prices has been largely responsible for the mountainous farm surpluses, and that abandonment of such supports in favor of a flexible system is indispensable to any sound farm program.

The President's veto message makes clear that his action was taken neither hastily nor irresponsibly. Mr. Eisenhower records his "intense disappointment and regret" in having to disapprove the bill. His decision, he assures the Congress, was reached "only after thorough consideration and searching my mind and my conscience." He neither minimizes the economic difficulties of the farm population, nor questions the need for constructive relief measures by government. On the contrary, he states categorically, "Our farm families are suffering reduced incomes. They had a right to expect workable and beneficial legislation to help solve their problems." These problems, he pointed out, arise from the "price-depressing surpluses".

But the proposed bill, the President stated, would not eliminate these surpluses.

As he explained:

> The soil bank proposal has been incorporated. This would be constructive, had it not been encumbered by contradictory provisions. The soil bank would provide an income incentive to farmers to reduce production temporarily so that surplus stocks might be reduced. Other provisions of this bill, however, would result in an equal or greater incentive to increase production and accumulate more surplus.

More specifically, the provisions found objectionable were: (1) return to rigid 90 per cent of parity price supports on "basic" crops; (2) using the higher of either "modernized" or old parity in calculating parity prices for wheat, corn, cotton, and peanuts; (3) "two-price" plans for wheat and rice; and (4) mandatory price supports for all feed grains.

The effect of these measures, the President said, "would be to increase the amount of government control and further add to our price-depressing surpluses." Supporting this contention is the fact that current farm surpluses were largely accumulated under the high, rigid price supports of years past.

Veto Effects Cushioned

Mr. Eisenhower, however, was not content with mere negative action in refusing to approve

a bad piece of legislation. He took positive steps to cushion the effect of the veto on farm prices and income where such action seems warranted in promoting a more orderly adjustment.

Thus he immediately requested the Congress to provide for a straight soil bank to be in operation before fall seeding for next year's crops; and he suggested that approximately $500 million in advance payments under this proposal could be made this year.

In addition, he ordered the Secretary of Agriculture, since there is little chance that full payments under the soil bank can be made this year, to raise supports of basic crops for 1956 to at least 82½ per cent of parity, and to boost dairy supports to the level called for in the vetoed bill. The following table shows the dollar and cents value, average farm basis, under the categories indicated:

Commodity	Support in 1955	Flexible Program 1956	President's Support 1956	Vetoed Bill 1956
Wheat (per bu.)	$2.06	$1.81	$2.00	$2.27
Corn (per bu.)	1.58	1.40	1.50*	1.65
Cotton (per lb.)	0.32	0.26	0.29	0.32
Rice (per cwt.)	4.66	4.04	4.50	4.90
Peanuts (per lb.)	0.12	0.11	0.11	0.12
Milk (per cwt.)	3.15	3.15	3.25	3.25
Butterfat (per lb.)	0.56	0.56	0.59	0.59

*This support requires compliance with acreage allotments; farmers in commercial areas who choose to ignore acreage restrictions are assured support at $1.25.

As the above table shows, dairy farmers will receive as much for butterfat and manufacturing milk as they would have realized under the vetoed bill. Coupled with cancellation of scheduled seasonal reductions in prices paid for fluid milk sold under federal marketing orders, these higher supports will materially increase dairy farm income. In addition, dairymen, particularly in deficit feed areas, stand to benefit by the lower supports for corn and other feed grains than called for in the bill.

Yet, despite lower supports, corn farmers too may be better off. In order to get support at $1.65 a bushel, they, under the bill, were required to place at least 15 per cent of their cultivated acreage into the soil bank. Because of the lateness of the season, it is extremely doubtful that many farmers would have made this adjustment. Now farmers in commercial areas are assured $1.50 a bushel for corn grown under allotments and $1.25 a bushel if they choose to ignore controls. Even this lower prop may be profitable enough for many efficient farmers to maximize corn acreage at the expense of soybeans, one of the few crops not expected to be in burdensome surplus.

The President also declared that, starting July 1, the Department of Agriculture would use over $400 million it has to boost prices of perishable products "where assistance will be constructive." This would be similar to the recent program in which over $100 million was spent to boost prices of hogs and lard. The Administration is also expected to request a further increase in funds for exporting surpluses under Public Law 480.

A Stop-Gap Program

It is evident that the program which has emerged is only stop-gap in character, to bridge over a crisis until something better can be devised. The question is to what extent the compromises that have been forced on the President may have the effect of purchasing immediate gains for the farmer at the expense of his longer-range welfare.

The higher the price supports the greater the incentive to expand farm production — when there is too much farm production already. The proposal for a soil bank, with its incentive payments to farmers to take land out of cultivation, may prove to be, in the words of the *Prairie Farmer*, "a useful tool to cut production for a short time," giving farmers "a chance to make adjustments to meet today's markets." But we cannot, as this authority observes, hope that it will keep down production over a long period.

This is particularly true if price supports are set at levels that induce farmers to cultivate more intensively their unrestricted acreage. The soil bank could, with improper pricing policies, prove to be as dismal a failure in limiting output as have acreage restrictions in the past. As the *Prairie Farmer* goes on to say:

> Trying to hold down production against rising efficiency on the farm, the government may find itself in a hopeless race, banking more and more acres. As the dam grows higher and higher, banked acres could become as great a problem as today's stored up surpluses. For if the government stopped or slacked off on incentive payments, the dam would break, bringing stored-up acres back into production to flood the market and bring down prices.

The Basic Problem

All this comes back to the basic problem of too many people trying to make a living out of farming. While politicians refuse to accept this fact, it is well recognized by many well-posted authorities, including such unquestioned friends of agriculture as Allan Kline, former president of the American Farm Bureau Federation. In an address last month he stated, "The basic cause of lower farm prices today is that too many people are engaged in agriculture."

Mr. Kline proposed vocational training and job placement to induce half a million farm families to leave agriculture for better opportunities elsewhere. He continued:

Now is the time to make the adjustment in agriculture while there is high income and employment and food consumption is at record levels.

Certainly Mr. Kline's statement cannot be impugned as coming from someone unsympathetic with the farm problem. There is simply no other solution than just such an occupational shift as he has suggested.

With the sweeping technological advances that have occurred in agriculture, bringing greater and greater mechanization, many farms today are too small to afford their owners a decent living. To attempt to keep these inefficient submarginal units by piddling relief payments is a dis-service to people who might be better off in other pursuits. From the standpoint of the economy at large, it is a lamentable waste of human resources.

"The Euthanasia of the Rentier"

The recent advancing tide of interest charged on borrowed money has led people to wonder what forces are behind the movement and where it will stop. Interest rates have been drifting irregularly upwards for ten years now. And the movement has come at a time when everyone had been pretty much agreed that the powers of government could and would insure cheap money forever.

Advancing interest rates are world-wide. Most astonishing is what has happened in the United Kingdom, the intellectual source of the cheap money gospel. The keynote of the new British budget, presented to Parliament last month, is the need for savings. Most publicity has been given to a "premium bond" project whereby interest will be payable on a lottery principle with tax-free prizes.

But this is only one facet of the drive for savings—as Chancellor of the Exchequer Macmillan put it — "to secure the welfare and solvency of the nation." Interest up to $42 a year on savings deposits will be exempted from income tax. A new issue of savings certificates will pay 7.3 per cent before income tax or 4.2 per cent free of income tax. This is almost as much as the 5 per cent a year compounded that British consumer prices have been rising on the average the last ten years. If the program — which also involves higher costs to borrowers — succeeds in retarding price inflation, it may once again pay to save in the country that was once the greatest capitalist nation on earth.

Savings are the raw material out of which people get mortgage money to finance the purchase of homes, governments get funds to cover deficits, and — last but not least — industry gets wherewithal to build plants and provide tools and machinery for the workman to use. For fifty years savings have been increasingly milked by progressive income taxes and inheritance taxation. The crowning blow was the policy, adopted twenty years ago, of using central banks to augment loan funds and drive interest rates down.

The Cheap Money Policy

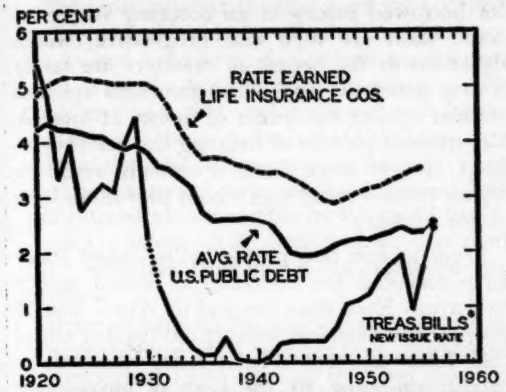
This was during the Great Depression when over-saving was alleged to be the cause of unemployment and falling prices. The celebrated British economist, J. M. Keynes, seeking full employment, rejected the principle that people needed rewards for saving. He urged "communal saving through the agency of the State", and the use of central banks free from the restraints of the gold standard to insure an abundance of money for capital investment. He prescribed "euthanasia" for the rentier: painless death for people living on interest. Besides low interest rates, Keynes advocated confiscatory income and inheritance taxes on the idea that government by this means could level down incomes and get into circulation money rich people were supposed to be hoarding.

The views of Lord Keynes (he was elevated to the peerage in 1942) had great influence on public policy, most notably in the English-speaking and Scandinavian countries inclined toward socialism. The break from the old gold standard, initiated by the United Kingdom in 1931, permitted "cheap money" policies to be carried to lethal extent. Open market operations drove up prices of gold and government securities and flooded the market with funds. Conservative investors saw their incomes shrink endlessly, and were driven to live off capital.

In the United States the initial instrument of the cheap money policy was the radical devaluation of the dollar in 1934. This was intended to raise prices, ease the money markets and facilitate deficit-financing. The high price offered drew in gold from all quarters of the earth, saturating the money market with idle funds. Later, when the bond market had sinking spells, the Federal Reserve bought government securities in the open market to sustain their prices and keep money rates down. Rates paid on long-term Treasury bonds were cut from 3¼ per cent partially tax exempt in 1934 to 2½ per cent fully taxable in 1941. Yields on U. S. Treasury bills dropped to practically nothing at all.

The Low-Water Mark

The financial demands of World War II forced governments — at least for the duration —to encourage saving as an antidote for inflation.



Net Interest Rate Earned on Life Insurance Companies' Investments, 1920-55; Average Rate Paid on U.S. Public Debt, June 30, 1920-55 and April 30, 1956; and Average Rate Paid on New Issues of U.S. Treasury Bills, Annually 1920-55 and January-April 1956.

***Treasury bills, first issued in 1929, were not regularly offered until 1931. Plottings for 1920-30 are averages of daily yields on 3-6 month Treasury certificates and notes.**

Central banks had to undertake huge purchases of government securities to keep interest rates from rising. But the immense public debts created out of depression and war financing gave a new reason to keep interest rates down after the war. Governments wanted to minimize interest costs on swollen public debts. The Governor of the Bank of Canada, discussing the establishment of a 1½ per cent discount rate in 1944, had the foresight to envisage the possibility that consumers' expenditures and capital development after the war might proceed at a rate which would overstrain productive capacity. But he saw "no prospect of . . . a situation arising . . . which would call for a policy of raising interest rates". Cheap money forever was a foregone conclusion.

In 1945-46, indeed, economists of the Keynesian school revived discussions of driving interest rates still lower. U. S. Treasury bond prices in the spring of 1946 rose to the highest levels ever recorded under assumptions that the Federal Reserve would support government bonds at fancy premiums so that the Treasury might borrow long-term money at 2¼ per cent or less. Bond prices hit their tops in the United Kingdom in the autumn of 1946 when the Chancellor of the Exchequer engineered a successful sale of 2½ per cents. Though it was not obvious at the time, the low-water mark on interest rates had been reached.

Savings Bonds

The United States Government put the squeeze on banks and savings institutions but gave the individual small saver an opportunity to buy Savings bonds. Placed on sale beginning in 1935, they offered, on limited amounts of funds, a return which could reach 2.9 per cent for people willing and able to wait ten years for the promised income. Rates earned by life insurance companies declined from 5 to 3 per cent, raising the cost of life insurance protection. Rates paid by banks on savings deposits dropped from 4 and 3 per cent to 1½ per cent or less. Social security legislation aided, among others, old folks living off interest albeit at a cost of some humiliation. Self-reliant people do not like to be dependent on others.

Even for the Savings bond investor, comparatively sheltered from interest rate decline, the experience was unrewarding. As the following table shows, people who bought Savings bonds and held them for a ten-year term have found that interest received has been insufficient to compensate for income tax payable and the "inflation tax" levied in the form of a shrinkage in the buying power of the dollar.

The Worm Turns

The upturn in interest rates required only a decision of government to stop trying to drive them down. All the Federal Reserve Board did in 1946 was to point out the inflationary pressures built up in the economy and abolish a largely inoperative special ½ per cent discount

Return on 1935-46 Savings Bond Issues After Income Tax and "Inflation Tax"

Bought for $75 in	Maturity value of $100 in	Initial (lowest) personal income tax rate	Income tax on $25 interest	Maturity value less income tax	"Inflation tax" — increase in cost of living index over the 10 yrs.*	Amount of "inflation tax"	Maturity value less income tax & "inflation tax"	Dollars of original investment lost	Average annual rate of loss
1935	1945	23.0%	†	$100.00	35.9%	$26.42	$73.58	$ 1.42	0.19%
1936	1946	19.0	†	100.00	44.2	30.65	69.35	5.65	0.75
1937	1947	19.0	†	100.00	55.7	35.77	64.23	10.77	1.44
1938	1948	16.6	†	100.00	70.5	41.35	58.65	16.35	2.18
1939	1949	16.6	†	100.00	71.4	41.66	58.34	16.66	2.22
1940	1950	17.4	†	100.00	71.6	41.72	58.28	16.72	2.23
1941	1951‡	20.4	$5.10	94.90	76.5	41.13	53.77	21.23	2.83
1942	1952‡	22.2	5.55	94.45	61.2	35.86	58.59	16.41	2.19
1943	1953‡	22.2	5.55	94.45	51.3	32.02	62.43	12.57	1.68
1944	1954‡	20.0	5.00	95.00	47.7	30.68	64.32	10.68	1.42
1945	1955‡	20.0	5.00	95.00	43.5	28.80	66.20	8.80	1.17
1946¶	1956‡	20.0	5.00	95.00	34.0	24.10	70.90	4.10	0.55

*Cost of living index for 1942-47 adjusted by the Council of Economic Advisers, according to the findings of the President's Committee on the Cost of Living, to show the wartime effects of changes in quality, availability of consumer goods, etc. †Income tax exemption allowed on interest from $5,000 or less principal value of Savings bonds issued 1935-40. ‡Continued interest accumulation optional for an additional ten year period. ¶Cost of living index for 1956 based on figures for first three months.

rate on advances to member banks secured by government securities maturing or callable in one year or less. At the same time, the Board specifically disavowed the desirability of higher levels of interest rates. Natural forces of the market took over.

It takes time for people to change their fundamental habits. The retreat from easy money was forced by a cumulatively widening public consciousness of the penalties on saving and the advantages of borrowing. For the ten postwar years the chronic problem of the Federal Reserve has been to fight inflation while at the same time protecting bonds from undue declines in price under the weight of offerings from holders wanting and needing to get better returns on their money.

In 1947, to gain a market for its huge holdings of 91-day Treasury bills, the Federal Reserve allowed their yields to rise modestly from the pegged level of ⅜ per cent. In 1948 the regular Federal Reserve discount rate was raised from the 1 per cent level established in 1937. Par support of Treasury 2½ per cent bonds was withdrawn in March 1951 after a Congressional investigation of the inflationary consequences of the pegging practice. Since 1948 the discount rate has moved in a range between 1½ and today's level of 2¾ per cent. Fully taxable U. S. bonds, save one issue which pays 3¼ per cent, trade below par.

In some other nations, facing more acute inflationary problems, the retreat from cheap money policies has been more dramatic. The Bank of England's discount rate, still 2 per cent as recently as 1951, was lifted in February from 4½ to 5½ per cent. British Treasury bills yield around 5 per cent. The Reserve Bank of New Zealand, which had a 1½ per cent discount rate from 1941 to 1953, has gone all the way to 7 per cent.

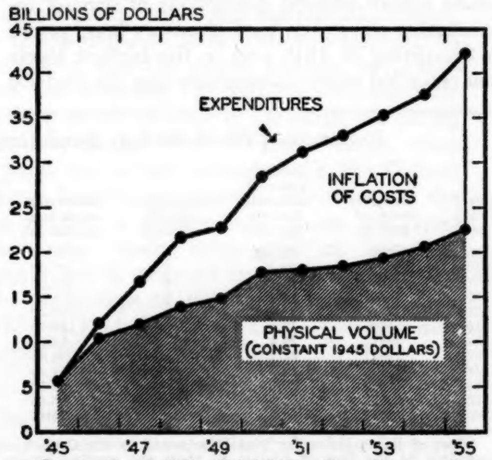
These changes represent belated official recognition of the injustice done the saver and the need for saving to finance economic growth and to maintain economic stability.

New Forces at Work

The long-prevailing theory has been that money rates are in a declining drift as the efficiency of capital rises and as the increased well-being of people gives them more capacity to save. These forces seemed to be at work during the 19th century in the United Kingdom, in the United States, and in other countries with stable money. But new forces have entered the equation. The natural trend is toward higher rates for borrowed money in an economy where income taxes are high and progressive, where deflations to the benefit of creditors are rarely if ever permitted, and where the cards are thus stacked against the lender of money at interest. Government policies of inflating the currency to keep interest rates down eventually result in higher interest rates than would prevail under a stable currency.

We have seen how people in the United States have accepted the invitation of cheap money to borrow. Ever since the end of World War II people have been increasingly mortgaging ahead their future incomes to enjoy today what will be earned tomorrow. By the force of government controls, which had involved practical shutdowns of home construction and passenger car production during the war, the total of consumer instalment debt and mortgage debt on 1-4 family homes was down to 14 per cent of annual take-home pay in 1945. By 1955 the total had risen all the way to an unprecedented 43 per cent.

Government deficits aside, the biggest use of borrowed money over the past ten years has been to finance construction, most notably the home-building boom with encouragements not only from easy terms but also from governmental guarantee, insurance, and subsidy programs. So much money has been drawn into use for building that construction costs for ten years now have been mounting at an average rate of 7 per cent a year compounded annually. The Department of Commerce estimates that total construction outlays rose from \$5.6 billion in 1945 to \$42.2 billion in 1955. But, as the chart shows, more than half of that \$36.6 billion increase is figured to represent inflation of costs.



Construction Activity, Total Dollar Expenditures and Physical Volume, 1945-55

This cost inflation doubles need for borrowed money to build and also tempts foresighted people to buy a home at the earliest possible moment with the biggest possible mortgage. For they have seen that well built and well located homes have been a bonanza investment and suspect that this will continue to be true. Home mortgage carrying costs are eased because taxes and interest are deductible on the individual income tax return. It is small wonder that mortgage demands have grown to insatiable proportions.

Business has had the same experience with rising construction costs, and has been supplementing ploughed back earnings by bond sales and bank borrowing to enlarge working capital and productive capacity. Moderate interest rates, the deductibility of interest payments from taxable income, and the height of corporate income tax rates, make borrowings a more inviting avenue of corporate finance than sales of stock. States and local governmental bodies have played their part, issuing heavily increased volumes of bonds to finance school and road building and other public improvements at rising costs.

Savers' Rate Consciousness

At the same time savers, pondering the losses which inflation has levied on them, have become more interest-rate conscious, and disposed to seek out better returns even though greater risk may be involved. An illustration is the flourishing growth of savings and loan associations, whose shares offer the appeal of higher interest rates to small savers. In the ten years ended December 31, 1955 savings capital of all U. S. savings and loan associations has grown from $7.4 billion to $32.3 billion. Competing for loanable funds, banks have been gradually moving up rates offered on savings and time deposits.

Furthermore, rising dividends have attracted growing numbers of individuals to common stocks as an investment. A not uncommon view is that we are in an age of inflation where good common stocks are more conservative for long-term holding than government bonds, particularly since the government "guarantees" that there will be no more depressions and deflations. The growing popularity of "mutual funds" is symptomatic of this tendency.

This same thinking affects corporate pension trustees, who naturally want to get the best returns prudently possible in order to lower pension costs or increase pension benefits. The tendency has been for larger percentages of corporate pension funds to move into common stocks on the expectation that dividend payments will rise over the years and that plough-back of earnings will increase the market value of the investment.

Trade unions, the last citadel of financial conservatism, have tended lately to join the movement, shifting from low-yielding U. S. bond investments to mortgages, housing developments, and corporate securities. In the "age of inflation" everybody finally becomes conscious of the need for better rates.

State legislatures have acted to improve opportunities of regulated investors, such as state pension funds, life insurance companies and mutual savings banks, to get higher returns. While unsuccessful so far, one major life company has sought powers to sell "variable" annuities under which reserves would be invested in part in common stock and annuity payments would vary with dividends received. The Teachers Insurance and Annuity Association actually has a modified plan of this type for the benefit of college professors optimistic as to the future of American business and doubtful as to the buying power of the dollar years hence.

The Future of Rates

The future of interest rates depends more than anything on confidence in the value of the dollar. Rates can be held down by balancing the federal budget, easing income tax rates, letting borrowers experience difficulties in raising funds when credit demands surge beyond availabilities of savings flows and normal growth, and inducing people to rely more on their own money and less on the other fellow's.

If the saver can trust the future value of the money he is lending he will be satisfied with a moderate return. If he loses faith, as experiences with extreme inflation teach, he will demand exorbitant rates — or denude the market of loan funds by fleeing to equities.

The discount rate advances, and increases in rates charged on borrowings and paid on savings, invite people to trust the dollar. The logical next step, to energize the supply of savings for investment, is to check government expenditures so that the public debt and income taxes can be reduced.

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